U.S. Senate
Republican Policy
Committee

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Legislative Notice

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No. 31

September 15, 1999

S. 625 – Bankruptcy Reform Act of 1999

Calendar No. 109

Favorably reported with amendments from the Committee on the Judiciary by a vote of 14 to 4 on May 11, 1999; additional and minority views filed; S. Rept. 106-49. All Republicans voted to report; they were joined by Senators Biden, Kohl, Feinstein, and Torricelli.

NOTEWORTHY

- The Bankruptcy bill itself, or a cloture vote in relation thereto, may be before the Senate soon.
- This bill has bipartisan support; there is widespread agreement that the bankruptcy system is in need of reform. In recent years, notwithstanding low unemployment and high wages, bankruptcy filings have increased significantly. The Committee's report opens with this sentence, "The bankruptcy system is currently in a state of crisis."
- The Department of Justice estimates that creditors lose $3.22 billion every year to a bankruptcy system that allows individuals *who could repay their debts* to file for bankruptcy [Report at 2]. Those costs are then passed along to all Americans in the form of higher prices and higher interest rates.
- S. 625 builds on the work of the 105th Congress. Last year, a bankruptcy conference report passed the House of Representatives by a vote of 300 to 125, but the Senate fell short: A motion to proceed to the conference report passed on a vote of 94 to 2, but then the conference report itself was successfully filibustered [see *Record Vote Analysis* No. 313 of Oct. 9, 1998]. Earlier, the Senate had overwhelmingly passed its own bankruptcy bill.
- S. 625 has many similarities to last year's conference report; however, to accommodate concerns raised by some Senators, it also has a more flexible means-test, additional consumer protections, and stronger protections for child support.
- The House passed a bankruptcy reform bill (H.R. 833) on May 5, 1999 [Senate Calendar No. 110]. The vote was 313 to 108.
- The Clinton Administration says it supports reform, but not the kind of reform that is moving in Congress. Last year, the Administration threatened to veto the conference report, and this year the Administration has threatened to veto the House-passed bill.

BACKGROUND

The Constitution gives Congress express power "To establish . . . uniform Laws on the subject of Bankruptcies throughout the United States." Art. I, §8, cl. 4. Bankruptcy laws have been a permanent part of the federal code for 100 years. The bankruptcy code was overhauled in 1978, and the 1978 act as amended governs all bankruptcy cases filed today.

S. 625 is motivated in large part by the explosion in consumer bankruptcies, which is especially troubling because the economy is healthy. "According to the Administrative Office of the U.S. Courts, there were 1,442,182 bankruptcy filings in 1998, of which 1,398,182 were consumer bankruptcies. Moreover, this record high number of bankruptcies follows three consecutive years of increases in bankruptcies." [Rept. at 2.] (The number of bankruptcy filings this year may be *below* the number for last year, however.) Based on research by the Congressional Budget Office, Senator Grassley says that bankruptcies cost each American household about $400 per year in higher costs for goods, services, and credit.

Some of the costs of bankruptcy were discussed in the June 17 hearings on the nomination of Lawrence Summers to be Secretary of the Treasury, where the following exchange occurred:

> Senator Grassley. "Would you agree, at least in a general way, . . . that bankruptcy is a way of transferring costs from one person, a bankrupt, to everyone else? In other words, would you agree that debt discharged in bankruptcy results in higher prices for goods and services as businesses have to offset losses?"
>
> Mr. Summers. "I think it is a complicated question, but certainly there is a strong tendency in that direction, and also towards higher interest rates for other borrowers who are going to pay back their debts."
>
> Senator Grassley. "So, in a sense, debts discharged in bankruptcy result in higher prices for everyone, including the poor. . . ."

The Judiciary Committee believes that the bankruptcy law itself is partly responsible for the explosion in personal bankruptcies. The Committee holds "the strong view" that "the bankruptcy code's generous, no-questions-asked policy of providing complete debt forgiveness under chapter 7 without serious considerations of a bankrupt's ability to repay is deeply flawed and encourages a lack of personal responsibility." [Rept. at 3.]

Some observers think the enormous increase in bankruptcies has less to do with the law or a lack of personal responsibility than with aggressive marketing by credit card companies and others who offer credit too freely. These observers point out that the increases in personal bankruptcy filings have been accompanied by increases in household debt-to-income ratios.

The Committee believes that S. 625 will "promote balanced reform of the bankruptcy laws while providing important new protections against abusive or deceptive creditor practices." [Rept. at 3.]

Background on Needs-Based Bankruptcy ("Means-Testing")

Under current law, individuals considering bankruptcy can proceed under Chapter 7 or Chapter 13, but about 70 percent of bankruptcy filings are under Chapter 7.

In **Chapter 7**, the debtor surrenders those assets which do not qualify for an exemption under the law, and the assets are sold to satisfy (in part) the demands of the creditors. Any debt that remains after the sale of the assets is erased (the law calls it "discharged"). (Chapter 7 proceedings are what most people have in mind when they speak of *bankruptcy.*)

Chapter 13, on the other hand, provides for the creation of a repayment plan to repay a portion of the debtor's debts using future earnings. Under Chapter 13, creditors are looking to the future earnings of the debtor rather than to the property he currently owns. When the debtor has made his payments as required under the repayment plan, any unpaid portion of his debt is discharged.

Prior to 1984, an individual contemplating bankruptcy could freely choose between Chapter 7 and Chapter 13. However, as more and more debtors *who had the means to repay some of their debts* chose Chapter 7, Congress amended the bankruptcy code to steer debtors toward Chapter 13 and repayment. "The focus of the effort was to require bankrupts who had the ability to pay a significant percentage of their debts 'without difficulty' to proceed under Chapter 13 instead of Chapter 7." [Rept. at 6.] However, the 1984 amendment used a vague term and a difficult test and Congressional intent was frustrated.

The 1984 amendment added a new part to the bankruptcy code (**section 707(b)**) allowing a Chapter 7 case to be dismissed if the court found there had been "substantial abuse" of the law. However, only the judge or the United States bankruptcy trustee, not a creditor or other party in interest, could make a motion alleging "substantial abuse." In the courts, the prevailing view of section 707(b) came to be that a debtor's filing for Chapter 7 relief even while having an ability to pay his debts was not enough, standing alone, to constitute "substantial abuse." Therefore, section 707(b) has failed to have the hoped-for effect of reducing abuse of the system, and S. 625 addresses the issue again (see below).

HIGHLIGHTS

"Means-Testing" to Protect the System

S. 625 allows a bankruptcy judge to dismiss a Chapter 7 case (or convert it into a Chapter 13 case if the petitioner consents) if the **system is being "abused"** (*not* "substantially abused" as under current law). A motion alleging abuse of the system can be filed by the trustee, by the court on its own motion, or (unlike current law) by any party in interest. The court is to **"presume abuse exists"** if the debtor can, based on his current income, repay at least 25 percent of his general unsecured debts, or $15,000 (whichever is less) over a five-year period. In determining the debtor's ability to repay his debts, the bill provides that his monthly expenses shall be determined using **I.R.S. standards** for the area in which the debtor lives.

Additionally, in order to protect debtors from an application of the means-test that is too rigid, the bill provides that a debtor may be able to demonstrate "special circumstances" that justify additional expenses or an adjustment to the debtor's income. The Committee emphasizes that the **"special circumstances" exemption** "must be based solely on financial considerations . . . and not on factors unrelated to a chapter 7 debtor's ability to repay his or her debts. . . . [S]pecial circumstances adjustments must not be used as a convenient way for debtors to choose a more expensive lifestyle." [Rept. at 7.]

Under S. 625, the Office of U.S. Trustee is **required to file a motion to dismiss or convert** a Chapter 7 case to a Chapter 13 case if the bankrupt's income for the year prior to declaring bankruptcy equaled or exceeded the higher of the state or national median income *and* the presumption of abuse applies. If the Office of U.S. Trustee believes that such a motion is not warranted, then it must file an explanatory statement with the bankruptcy court explaining why a motion to dismiss or convert is not appropriate.

Under the bill, **creditors and private trustees may present evidence of abuse** to a bankruptcy judge. However, to protect filers who have low incomes, creditors are prohibited from filing a motion to dismiss or convert to chapter 13 if the filer's income is below the national or state median.

S. 625 contains **penalties for creditors** who attempt to harass or intimidate bankrupts by filing, or threatening to file, those motions described above. Thus, contrary to the assertions of some critics, there are real and meaningful reasons why creditors will not use their right to file 707(b) motions to harass or coerce debtors.

S. 625 also gives **important new financial incentives to trustees** for ferreting out bankrupts who have repayment capacity, and it provides **penalties for bankruptcy attorneys** who recklessly steer individuals with repayment capacity into chapter 7.

Consumer Protections

S. 625 contains several important reforms which will protect individuals who face unnecessary and unfair harassment from creditors. S. 625 requires the U.S. Attorney General to designate prosecutors and investigators to enforce current criminal statutes which protect debtors from deceptive or coercive collection practices. When enforced, current laws have proven highly effective in punishing illegal creditor conduct. By **committing substantial new resources to fighting abusive creditor practices,** the Committee intends for the Department of Justice to step up enforcement of these under-used statutes.

Under current law, the mere filing of a bankruptcy petition generally creates an automatic stay that stops all collection efforts, all harassment, and all foreclosure actions (see, 11 U.S.C. §362). Sec. 203 of the bill uses the **automatic stay provisions to protect debtors** against threatening motions by creditors that they don't intend to file or that have no reasonable expectation of success. Also, section 204 permits a bankruptcy court to refuse to approve a reaffirmation if it is the result of a threat of action the creditor could not take or did not intend to take.

S. 625 also provides that State law enforcement officials can **enforce State consumer protection laws.** This provision is necessary as some State law enforcement officials have voiced concern that the remedies provided in the bankruptcy code could be construed to preempt these State laws.

Section 201 of the bill contains a provision which **penalizes creditors** who refuse to negotiate reasonable repayment schedules outside of bankruptcy. Under this provision, the amount that a creditor may collect in bankruptcy can be reduced if a debtor makes a reasonable offer of repayment at least 60 days prior to declaring bankruptcy and the creditor rejects this offer.

Reducing Abuses of the System

Many of the worst abuses of the bankruptcy system involve individuals who repeatedly file for bankruptcy with the sole intention of taking advantage of the law's automatic stay. S. 625 contains **restrictions on repeat filers** so that if a bankrupt has filed for bankruptcy before, and that case was dismissed, the bankrupt will not get the benefit of the automatic stay. The Committee believes that "this change will dramatically reduce the number of frivolous bankruptcy cases." [Rept. at 10.]

The bill requires **random audits** of bankruptcy petitions to verify the accuracy of information reported. The Committee is concerned that there is little incentive for individuals to list all of their assets or fully disclose their financial affairs, including their income and living expenses, when they file for bankruptcy.

S. 625 requires the Administrative Office of the U.S. Courts to provide special safeguards to ensure the **confidentiality of tax information** which bankrupts are required to file with their court papers.

More Protections for Child Support

According to some estimates, more than one-third of bankruptcies involve spousal and child support orders. And in about half of those cases, women were creditors trying to collect court-ordered support from their former husbands. Enforcement of these support orders is essential for thousands of families struggling to maintain self-sufficiency.

Title II, subtitle B, of S. 625 contains **all of the provisions of last year's conference report** which enhanced the position of child support and alimony claimants in bankruptcy proceedings. In addition, section 219 of S. 625 contains **new provisions protecting child support:** it requires bankruptcy trustees to notify child support creditors of their right to use State child support enforcement agencies to collect outstanding amounts due; and it permits general creditors to disclose to child support claimants the last known billing address of a bankrupt who owes child support or alimony.

In response to concerns that a new category of nondischargeable debts (those debts incurred within 70 days before filing for bankruptcy) could pit child support and alimony claims (both of which are nondischargeable under current law) against aggressive creditors, section 314 of the bill provides that the new category will not apply to bankrupts who owe child support or alimony.

Last year's bill and conference report provided that State-enforced child support orders would always be preferred over other creditors. This year's bill extends similar protections to support orders where the State is not the collector. This is an important improvement because many families, perhaps as many as half, do not have their child support orders enforced by a State child support agency.

Taken together, the Committee believes that child support and alimony claimants are in a far better position under S. 625 than under current law.

Strengthening Business Provisions

S. 625 largely retains the business bankruptcy provisions contained in last year's conference report. Although business filings are low, the Committee believes that several changes to chapter 11 should be made. Accordingly, S. 625 speeds up chapter 11 proceedings for small business debtors, enacts recommendations of the United Nations Commission on International Trade Law regarding transnational bankruptcies, and clarifies the treatment of tax claims in bankruptcy.

New Bankruptcy Judges

S. 625 authorizes 18 new temporary bankruptcy judgeships around the country, and extends five other ones. The bill also includes "a modest reporting requirement" for travel which is not related to a judge's caseload.

ADMINISTRATION POSITION

As of press time, no Statement of Administration Policy (SAP) had been received on the Senate bill (we are told, however, that one is being drafted). On May 5 the Administration did issue a SAP that strongly opposed the House bill. Among other criticisms levied, that SAP said: "The bill focuses on perceived abuses of the bankruptcy system by debtors without adequately addressing abuses by creditors, and takes an excessively rigid approach to limiting access to discharge of debts under Chapter 7 of the Bankruptcy Code."

COST

"CBO estimates that implementing S. 625 would cost $218 million over the 2000-2004 period — $207 million in discretionary spending, subject to appropriation of the necessary funds, and $11 million in mandatory spending. CBO also estimates that enacting this bill would increase receipts by about $2 million over the next five years. Because this bill would affect direct spending and receipts, pay-as-you-go procedures would apply. . . ." [Rept. at 66.]

OTHER VIEWS

Additional Views

Senator Kohl supported the bill in Committee but believes the bill still requires "significant improvement." In particular, he cites the abuses in the homestead exemption and "cramdowns" for car loans (the bill proposes to give lenders on car loans a secured interest in the amount of the loan rather than in the value of the car). He also says something needs to be done about lending practices: "The credit card industry has played no small role in the explosion of consumer debt and consumer bankruptcies." [Rept. at 77.]

Senator Feinstein supports the bill but is concerned that it does not address a root cause of many bankruptcies, which she believes to be the explosion of consumer credit. "Any meaningful bankruptcy reform must address the irresponsible actions of certain segments of the credit card industry. Last year, the credit card industry sent out a record 3.45 billion unsolicited offers. That's over 30 solicitations to every household in America. . . . Not surprisingly, credit card debt has increased with the flood of solicitations. . . . The amount of credit card debt outstanding at the end of 1997 was $422 billion, twice as much as the amount in 1993." [Rept. at 78.]

Senators Torricelli and Kohl believe that S. 625 is "significantly improved over last year's Conference Report," but they believe the bill still falls short and in some respects is not equitable. They review the practices of the credit card industry and then treat the following issues separately: means-testing, liability of the debtor's attorney, nondischargeability of debts, and reaffirmations. Some of these issues are to be addressed by the Grassley-Torricelli amendment that will be offered on the floor.

Minority Views

Senators Leahy, Feingold, Kennedy, and Schumer filed nearly 40 pages of Minority Views. They oppose the bill-as-reported because "as a practical matter, it will make bankruptcy unavailable for the honest but unfortunate families for whom the system was intended and who will never be able to repay their debts." [Rept. at 121.]

POSSIBLE AMENDMENTS

Amendments are likely, and numerous amendments have been talked about. Senators Grassley and Torricelli have prepared a joint amendment to address some of the lingering issues in a bipartisan way. Unrelated amendments, such as minimum wage, also are anticipated.

Relevant amendments may include the means test itself and the formula for the means test; nondischargeability of certain debts; protecting education savings accounts and retirement accounts during bankruptcy proceedings; credit practices, including the offering of credit to persons under age 21 and required disclosure of the costs of credit; the homestead exemption; strengthening further the preferred status of child support and alimony obligations; bankruptcy fraud; and other issues.

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